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In the Supreme Court of the United States

OCTOBER TERM, 1936

No. 27

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ILLINOIS LIFE INSURANCE COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 21–26) is reported in 30 B. T. A. 1160. The opinion of the Circuit Court of Appeals (R. 31–36) is reported in 80 F. (2d) 280.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered November 26, 1935 (R. 37). Petition for rehearing was filed December 16, 1935 (R. 37), which was denied January 9, 1936 (R. 37). The petition for a writ of certiorari was filed April 7, 1936, and the writ was granted May 18, 1936 (R. 38). The jurisdiction of this Court rests on Sec-

tion 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether amounts held by respondent, a life insurance company, at the beginning and end of the calendar year 1929, to meet its liabilities to the holders of its then outstanding survivorship investment policies of life insurance on account of so-called "survivorship investment funds" and "additional liability on survivorship investment policies contingent on payment of deferred and uncollected premiums" constituted "reserve funds required by law" within the meaning of Section 203 (a) (2) of the Revenue Act of 1928.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved will be found in the Appendix, *infra*, pp. 34–36.

STATEMENT

The facts in the case were stipulated (R. 9) as shown in the transcript of proceedings (R. 9–11). They may be summarized as follows:

Respondent is an Illinois corporation engaged in the business of writing and issuing policies of life insurance on the lives of individuals, with its home office in Chicago, Illinois (R. 9–10).

During and prior to the calendar year 1929 respondent issued so-called survivorship investment policies of life insurance (R. 10). A specimen copy designated "20 Payment Life-Survivorship Investment Policy Premium payable for 20

years -Non-Participating'' is set forth in the record as "Joint Exhibit A" (R. 11–20).

Said policies contain the following provision (R. 15):

SURVIVORSHIP INVESTMENT FUND

> The company guarantees that it will set aside, from each full year's premium paid to the Company after the first and to and including the twentieth, on account of this policy, the amount set forth as the Annual Contribution at the bottom of the Table of Payments on the fourth page hereof. The amounts so set aside shall be placed in a fund to be known as "The Survivorship Investment Fund", applicable to policies on the Survivorship Investment Plan issued in the same calendar year as this policy. The Company agrees that no deductions shall be made from said fund for any purpose whatsoever but that all contributions to said fund shall be accumulated at the rate of three and one-half per cent per annum, compound interest from the dates of the respective payments. The Company further agrees to apportion to this policy, as a Survivorship Investment, provided the Insured hereunder shall survive to the twentieth anniversary of the date hereof and that all premiums hereon have been paid, and not otherwise, a sum bearing the same proportion to the total amount of said fund as the total contributions thereto from premiums paid on this policy bear to the aggregate total contributions thereto from premiums paid

on all policies in the Survivorship Investment Class issued in the same calendar year as this policy and that are in force at the end of twenty years from their respective dates of issue, and on which all premiums have been duly paid. For the purpose of this provision a premium waived under Disability Provisions shall be held and construed as a premium paid.

The Company will furnish the Insured hereunder, upon his written request after this policy shall have been in force more than three years, a statement of the amount of this policy's proportionate share of the Survivorship Investment Fund then accumulated and held awaiting apportionment, without deduction, at the expiration of the Survivorship Investment Period.

and further contain the following (R. 16):

OPTIONAL SETTLEMENTS AT THE END OF TWENTY YEARS

A. The Insured may continue this policy as a Fully Paid-up policy, no further payment of premiums being required, and receive in addition thereto:

1. A cash payment of the Survivorship Investment hereto apportioned; or

2. A Fully Paid-up Non-Participating Life Policy, subject to satisfactory evidence of insurability, for such amount as will be purchased by the Survivorship Investment hereto apportioned, at the Company's then published single premium rate applicable at the then attained age of the insured; or

B. The Insured may surrender this policy and receive:

3. A cash payment of the Entire Cash Value, namely: the Guaranteed Cash Surrender Value of $6,100.00, and in addition thereto the Survivorship Investment hereto apportioned.

NOTE.—At the expiration of the Survivorship Investment Period, a statement will be rendered the Insured, setting forth the values of the above settlements. If the Insured fails to exercise his option to elect one of the aforesaid settlements, and to notify the Company thereof in writing at its Head Office within three months from the end of the Survivorship Investment Period, it is agreed that Settlement No. 1 shall automatically apply.

The specimen policy calls for the payment of an annual premium of $379.90, out of which there is set aside each year (from the second to the twentieth years) the sum of $64.60 in the "survivorship investment fund." (R. 20.)

Respondent's liabilities pursuant to the agreements contained in and peculiar to said survivorship investment policies as at December 31, 1928, and as at December 31, 1929, were as follows (R. 10):

	December 31, 1928	December 31, 1929
Survivorship investment funds	$3,249,580.06	$3,342,162.91
Additional liability on S. I. policies contingent on payment of deferred and uncollected premiums	48,707.53	47,334.82
Total	3,298,287.59	3,389,497.73

Respondent in its 1929 income tax return claimed and took as a deduction from gross income four per cent of the mean of said amounts of $3,298,-287.59 and $3,389,497.73, namely $133,755.71, on the ground that said amounts constituted "reserve funds required by law" within the meaning of the Revenue Act of 1928.

The Commissioner by an amendment to his answer before the Board (R. 8) assigned as error his failure to disallow the deduction claimed and thereupon asserted a deficiency on account thereof.

The Board of Tax Appeals, four members dissenting, held that said amounts of $3,298,287.59 and $3,389,497.73 held by respondent at the beginning and end of the calendar year 1929, respectively, constituted "reserve funds required by law" within the meaning of the Revenue Act of 1928 (R. 23–25) and allowed the claimed deduction. The Circuit Court of Appeals denied the Commissioner's petition for review.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that a fixed liability, which might in the future be converted into life insurance at the option of a policyholder but which had not been so converted during the tax year, is one against which a technical insurance reserve such as is contemplated by Section 203 (a) (2) of the Revenue Act of 1928, may be set up and maintained.

2. In holding that the Survivorship Investment Fund with accumulations thereon held at the be-

ginning and end of the calendar year 1929 constituted "reserve funds required by law" within the meaning of Section 203 (a) (2) of the Revenue Act of 1928.

3. In holding that respondent's liability on account of survivorship investment funds and additional liability on account of survivorship investment policies contingent on payment of deferred and uncollected premiums, against which respondent held so-called reserves at the beginning and end of the calendar year 1929, constitute "reserve funds required by law" within the meaning of Section 203 (a) (2) of the Revenue Act of 1928.

4. In holding that the legal reserves required to be maintained by respondent during the year 1929 under the laws of the State of Illinois included the amounts set aside by respondent in its survivorship investment fund, with accumulations thereon, and respondent's liabilities on survivorship investment policies contingent on the payment of deferred and uncollected premiums.

5. In affirming the decision of the Board of Tax Appeals and denying the Commissioner's petition for review.

SUMMARY OF ARGUMENT

The term "reserve" or "reserve funds required by law" has a special, technical, and peculiar meaning in the law of insurance. This has been established by the decisions of this Court in *McCoach* v. *Insurance Co. of N. Amer.*, 244 U. S. 585; *Maryland Casualty Co.* v. *United States*, 251 U. S. 342;

United States v. *Boston Insurance Co.*, 269 U. S. 197; *New York Life Ins. Co.* v. *Edwards*, 271 U. S. 109, and by the recent decision of this Court in *Helvering* v. *Inter-Mountain Insurance Co.*, 294 U. S. 686.

As applied to life insurance these terms mean, as is shown by the last of the above cases, a sum of money *actuarially* determined upon the basis of a selected table of mortality plus an assumed rate of interest in accordance with state law—in the case at bar upon the basis of the American Experience Table of Mortality with interest at 3½ per centum per annum under the laws of the State of Illinois—which is held against *life risks* on policies in force and unmatured. The amounts here in controversy were neither actuarially determined nor were they held against life risks. They were investment funds bearing a fixed rate of interest payable to the survivors. The liability of the company could be determined at any time without reference to any mortality tables. It was a fixed and definite liability on the part of the company. So far as the individual policyholder was concerned, the persons to whom the fund would be paid were undetermined and the amount which each beneficiary would receive was undetermined. But it was the policyholder and not the company who took the risk of receiving more or less, dependent upon the number of deaths. The amount which the company would have to pay was fixed and did not change with the number of deaths.

Therefore, these reserves constituted *solvency* reserves, which the respondent, under the laws of the State of Illinois, was required to carry as a liability distinct and separate from its life insurance reserve. No part of these amounts had been used to pay premiums or to purchase life insurance. During the year 1929 no part could have been so used. Upon the maturity of the policy at the end of twenty years a surviving policyholder could use his distributive share for any purpose, including, of course, the purchase of insurance from this or any other company, subject to satisfactory evidence of insurability. The option given in the policy to purchase insurance is not in fact an option, but only a suggestion. Life insurance reserves are those held to meet life insurance in force, not funds which may or may not be used to purchase life insurance in the future.

The decisions of the Board of Tax Appeals and the Circuit Court of Appeals are based upon misconceptions of the nature and character of the legal reserve of a life insurance company and its relation to the amounts here in issue.

ARGUMENT

The instant case again presents for the consideration of this Court the following question: What constitutes, within the meaning of the Federal statutes, a "reserve" or "reserve funds required by law" in the case of a life insurance company?

The policy contracts with which we are here concerned contain two distinct features: (1) a 20-payment *life insurance* contract against which the *net premium* or *legal reserve* must be held (this reserve deduction has already been allowed and is not here in dispute), and (2) a survivorship investment non-life insurance contract against which only so-called *solvency* reserves must be maintained.

The stipulated facts in the case show (R. 10) that at December 31, 1928, and December 31, 1929, respondent held $3,298,287.59 and $3,389,497.73, respectively, to meet its liabilities pursuant to the agreements, referred to in (2) above, contained in and peculiar to certain so-called survivorship investment policies of life insurance then outstanding. Four per cent of the mean of these amounts held, respectively, at the beginning and end of the calendar year 1929, or $133,755.71, respondent claimed as a deduction from gross income in making its 1929 income tax return on the ground that said amounts constituted "reserve funds required by law" within the meaning of Section 203 (a) (2) of the Revenue Act of 1928, *infra*. Respondent's contention, as above indicated, was sustained by the Board of Tax Appeals and by the Circuit Court of Appeals.

We contend that the amounts so held by respondent at the beginning and end, respectively, of the calendar year 1929, pursuant to the agreements contained in its outstanding survivorship investment

policies, were fixed liabilities of the company and not "reserve funds required by law" within the meaning of either the Revenue Act of 1928 or the laws of the State of Illinois.

I

THE TERM "RESERVE" OR "RESERVE FUNDS REQUIRED BY LAW" HAS A SPECIAL AND TECHNICAL MEANING IN THE BUSINESS OF INSURANCE AND IN THE FEDERAL STATUTES; IT REFERS TO A SUM, ACTUARIALLY COMPUTED ON THE BASIS OF MORTALITY TABLES, PLUS AN ASSUMED RATE OF INTEREST, WHICH WILL BE SUFFICIENT TO PAY LIFE INSURANCE RISKS WHEN THEY BECOME DUE

In *Helvering* v. *Inter-Mountain Insurance Co., supra,* this Court considered the meaning of the term "reserve" or "reserve funds required by law", within the meaning of Section 245 (a) (2) of the Revenue Act of 1921, reenacted as Section 203 (a) (2) of the 1928 Act here in issue. The company had contended that matured, unsurrendered, and unpaid coupons attached to so-called coupon policies of life insurance, which had become unconditionally due and payable on demand to their respective holders, constituted "reserve funds required by law." The amounts represented by these coupons when they became due had been left with the Company to accumulate at compound interest at the rate of 3½ percent per annum. A fund was thus created which the insured at his option might apply to the payment of premiums or withdraw in cash. Certain other options were available to the insured, none of which had been, or could have been, exercised during the taxable year.

One of these was the option to surrender his policy at its maturity in twenty years, together with all coupons attached thereto at date of issue, and to receive a paid-up policy for the original face amount plus an amount then purchasable with the coupon fund due him. This Court in disposing of the case said (p. 690):

> The word "reserve" has many meanings. * * * In life insurance the reserve means the amount, accumulated by the company out of premium payments, which is attributable to and represents the value of the *life insurance elements* of the policy contracts. The premiums include enough, over and above what is needed to maintain proper insurance reserves, to provide for the discharge of coupon liability according to the terms of the policy. The coupon values are the equivalent of cash and may be used to pay premiums on the face amount of the policy, to procure additional insurance, to lessen the number of annual premiums, or otherwise to obtain insurance protection. The amounts so applied cease to exist as coupon liabilities and automatically become a part of the life insurance reserves. These differ essentially from coupon liability. Life insurance matures only upon the death of the insured and the life reserve is based upon *that* contingency, whereas liability on the matured coupons depends upon no contingency. *It follows that the insurance reserves alone constitute the base on which the deduction is to be com-*

> *puted.* Reserves against matured coupons are excluded. *McCoach* v. *Insurance Co. of N. A.*, 244 U. S. 585, 589. *United States* v. *Boston Insurance Co.*, 269 U. S. 197, 202. *New York Life Ins. Co.* v. *Edwards*, 271 U. S. 109, 119. *Duffy* v. *Mutual Benefit Ins. Co.*, 272 U. S. 613, 618–619. *Continental Assurance Co.* v. *United States*, 8 F. Supp. 474. (Italics supplied.)

This case follows the decisions in *McCoach* v. *Insurance Co. of N. Amer.*, 244 U. S. 585; *United States* v. *Boston Insurance Co.*, 269 U. S. 197; and *New York Life Ins. Co.* v. *Edwards*, 271 U. S. 109, which have consistently upheld the principle that the term "reserve" or "reserve funds required by law" has a special and technical meaning in the business of insurance. These cases have made it clear that in any type of insurance the fund must be one held against an insurance risk. The term does not include liabilities which can be computed by the simple addition of interest to payments made. If the liability can be so computed, the contingency that the claim might not have to be paid at all, as in the case of litigated claims, or the uncertainty as to who the beneficiary might be, as in the case of unreported death losses, does not make the funds held against those claims a reserve. With respect to life insurance, the term means a fund actuarially computed upon the basis of a selected table of mortality, plus an assumed rate of interest, held to meet *life risks* on policies of *life insurance* in force and unmatured.

This conception of the term "reserve" has been departed from only in a single dictum in *Maryland Casualty Co.* v. *United States,* 251 U. S. 342, 350, in which the Court included as a part of the "reserve", "claims accrued, but contingent and indefinite as to the amount or time of payment." That dictum, however, was expressly overruled in *United States* v. *Boston Insurance Co.,* 269 U. S. 197, where the Court said (p. 203):

> Upon a re-examination of the record it becomes plain that we misapprehended the opinion and ruling of the lower court; also that the reason advanced to support our conclusion is insufficient * * *. The finding that the Insurance Department of Pennsylvania, pursuant to statute, had at all times since and including 1909 required claimant to keep on hand, as a condition of doing business in the State, "assets as reserves sufficient to cover outstanding losses", without more, was not sufficient to justify the deduction of the reserve as one required by law to be maintained, within the meaning of the Act of Congress. This had been announced by *McCoach* v. *Insurance Co.*

All of the cases last cited involved Revenue Acts[1] enacted prior to the Revenue Act of 1921. While Congress adopted a new plan for the taxation of

[1] Act of August 5, 1909, c. 6, 36 Stat. 11, 112, Sec. 38; Act of October 3, 1913, c. 16, 38 Stat. 114, 166, 172, Sec. II G. (b); Revenue Act of 1916, c. 463, 39 Stat. 756, 767–768, Sec. 12 (a) Second; Revenue Act of 1918, c. 18, 40 Stat. 1057, 1077–1079, Sec. 234 (a) (10).

life insurance companies in the latter Act, there is no indication of a purpose to give the term "reserve funds required by law" a new meaning. Under prior Acts the gross income of life insurance companies included their premium receipts, and they were permitted to deduct the amounts paid on policies (except as dividends), and the net addition required by law to be added to their legal reserves. The inclusion of premium receipts with corresponding deductions was found to be unsatisfactory, and in the Revenue Act of 1921, with the approval of at least most of the life insurance companies, Congress substituted a new basis for computing the tax. See dissenting opinion of Mr. Justice Brandeis in *Nat'l Life Ins. Co.* v. *United States,* 277 U. S. 508, 522–523. It was provided that the gross income should consist of investment income, that is, income from "interests, dividends, and rents" (Sec. 244 (a), Revenue Act of 1921), and in order to ascertain the net taxable income, nine classes of deductions were allowed, one of which is that here in issue.

It has been shown that this term "reserve" or "reserve funds required by law" has a special and technical meaning in the business of life insurance. It will be helpful to consider briefly how such "reserve" is calculated; among those at all familiar with the business there is no dispute as to how this is done. *Jefferson* v. *New York Life Insurance Co.,* 151 Ky. 609, 616.

In Yale Readings on Insurance—Life, pp. 193, 194, it is said:

> The laws of the several states prescribe the maximum rate of interest that may be assumed and the *mortality table* that shall be used, in computing the reserve or net value of a company's policies. This requirement is termed the *legal standard of valuation.* The net value computed by the *legal standard* is termed the *legal net value or legal reserve.* (Italics supplied.)

It has been said that the "net premium coming due is the foundation of the reserve." *Fink* v. *Northwestern Mut. Life Ins. Co.,* 267 Fed. 968, 973 (C. C. A. 7th).

In level premium life insurance, here in question, the "net premium" is calculated, first, by adopting an accepted table of mortality, showing the death rate for each age of life; and, second, by adopting an assumed rate of interest such as the company may safely expect to realize on its invested assets for the duration of all its policies. With these two factors, it is calculated just what sum each insured must pay yearly in advance so as to put the company in funds with which to pay all outstanding policies as they become claims, provided deaths occur exactly in accordance with the table of mortality, and also provided the rate of interest on the company's invested funds is exactly the same as the rate assumed in calculating its premiums. The sum ascertained in this way is

called the net or mathematical premium and is commonly referred to as the net premium reserve. *New York Life Ins. Co.* v. *Edwards,* 8 F. (2d) 851, 852 (C. C. A. 2d); *State ex rel. Supreme Lodge K. P.* v. *Vandiver, Supt. Ins.,* 213 Mo. 187. Under former Revenue Acts the net addition to this premium reserve was one of the deductions allowed from gross income.

Since under the Revenue Act of 1921, and subsequent Revenue Acts,[2] underwriting income (premium receipts) is not included in the gross income of life insurance companies, the deduction of the mortality content in the "net or mathematical premium" could no longer be permitted; accordingly, the deduction of the net addition to the reserve funds required by law was eliminated. There still remained for consideration, however, the interest content in the "net or mathematical premium", since it was clear that a portion of the interest, dividends, and rents received by a life insurance company must be used each year in maintaining the legal reserve, that is, in adding to it on the basis of a certain interest rate, varying from 3% to 4%, according to the requirements of the statutes of the several States. Since gross income included all interest, dividends, and rents received, Congress allowed the deduction of that portion thereof in-

[2] Section 244 (a) of the Revenue Acts of 1921, c. 136, 42 Stat. 227; 1924, c. 234, 43 Stat. 253; 1926, c. 27, 44 Stat. 9; and Section 202 (a) of the Revenue Act of 1928, c. 852, 45 Stat. 791.

cluded in the gross income which was required to mature the policy as a life risk, namely, the interest element. Accordingly Congress provided for the deduction of 4 per centum of the mean of the reserve (the highest percent required to be credited thereto by any of the state laws), and based the deduction upon the mean of the reserves held at the beginning and end of the taxable year.

The deduction allowed by Section 245 (a) (2) of the Revenue Acts of 1921, 1924, and 1926 and by Section 203 (a) (2) of the Revenue Act of 1928 is perfectly consistent with that permitted by prior Acts. Both were deductions of the portion of gross income defined by the Act which was required to be held in the insurance "reserve." Since in the later Acts premiums were not considered gross income, the only part of the taxable income which went into the reserve was the interest element. Therefore, only the interest required to be added to the reserve was allowed as a deduction. The principle, however, is the same and no different meaning is to be attributed to the term "reserve" under the later Acts. See *Massachusetts Mut. Life Ins. Co.* v. *United States,* 56 F. (2d) 897 (C. Cls.); *Standard Life Insurance Co. of America* v. *Commissioner,* 13 B. T. A. 13, 27.

In view of the foregoing, we submit that the term "reserve funds required by law" as it is used in the Revenue Act of 1928 does not embrace everything required as a reserve by state statute or state official, that its special and technical meaning for

life insurance purposes contemplates a fund actuarially computed, set aside from premiums, and built up with accretions from interest to meet life risks upon life policies in force and unmatured. Other reserves, although required by state law, are mere solvency reserves and not the special and technical reserve peculiar to life insurance contemplated by the Act.

II

THE FOUR PER CENT OF THE MEAN OF THE SO-CALLED RESERVES IN QUESTION IN THIS CASE IS NOT AN ALLOWABLE DEDUCTION UNDER SECTION 203 (a) (2) OF THE REVENUE ACT OF 1928

The statutes of Illinois make the same distinction between life insurance reserves and solvency reserves which has been made by this Court in the foregoing decisions. This appears from the provision of Cahill's Illinois Revised Statutes, 1929, c. 73, par. 331, Sec. 10, p. 1542, in force during the year 1929, covering the annual valuation of policies of life insurance companies and the basis upon which the reserves of a life insurance company under the laws of that State is calculated, that section, so far as deemed material here, providing:

> The Department of Trade and Commerce shall annually make valuations of all outstanding policies, additions thereto, unpaid dividends and all other obligations of every life insurance corporation doing business in

> this State. All valuations made by it or by its authority shall be made upon the *net premium* basis. The legal minimum standard for valuation of contracts issued before the first day of January 1908, shall be the Actuaries' or Combined Experience Table of Mortality with interest at 4 per centum per annum and for valuation of contracts issued on or after said date *shall be the American Experience Table of Mortality with interest at 3½ per centum per annum.* (Italics supplied.)

Thus under the laws of the State of Illinois all valuations of life insurance policies "shall be made upon the net premium basis" and the legal minimum standard of valuation after January 1, 1908, shall be "the American Experience Table of Mortality with interest at 3½ per centum per annum."

It is undisputed that the amounts held by respondent at the beginning and end of the calendar year 1929, respectively, in the Survivorship Investment Fund were required to be "carried as a distinct and separate reserve liability" under the provisions of Section 1 (5–c) of the Laws of Illinois, 1907, p. 367, as amended, and in force during the year 1929 (see Cahill, Illinois Revised Statutes, 1929, c. 73, par. 375, Section 1 (5–c), p. 1549), which, among other things, provides:

> * * * that if any company shall issue any nonparticipating policy under the terms of which any stipulated part of premiums received is to be placed in a separate fund

> for subsequent apportionment, such company shall furnish the Department of Trade and Commerce each year * * * a statement showing any and all amounts provisionally set apart, ascertained or calculated or held awaiting apportionment upon such policies according to classes, at the beginning of said year, the additions made to the said fund during the year with the source from which such additions arose, the deductions made from the said fund (if permitted by the contract) during the year with the reasons therefor and the amount of said fund at the end of the year; *which shall be carried as a distinct and separate reserve liability of the company* for the benefit of the classes of policies from the premium payments on which the sum was accumulated. *No part of said fund prior to the time of distribution stipulated in the contract, shall be considered in determining the loan and cash and other surrender values provided for by this Act.* * * * No such policy shall be issued which by its terms shall provide that more than twenty-five percent of the annual premium shall be placed in such fund, nor shall any such provision be made a part of a term insurance policy. (Italics supplied.)

Thus respondent was required to have on hand not only the legal reserve peculiar to life insurance contracts calculated upon the basis of "the American Experience Table of Mortality with interest at 3½ per centum per annum", but in addition "a

distinct and separate reserve liability" not computed on mortality tables.

The distinction made by the Illinois statutes between life insurance reserves and solvency reserves is further emphasized by the provision in the statutes that "No part of said fund prior to the time of distribution stipulated in the contract, shall be considered in determining the loan and cash and other surrender values provided for by this Act."

That the Survivorship Investment Fund here in issue did not represent life insurance in force will be shown by an examination of the "Optional Settlements at the End of Twenty Years" (R. 16).

Under these optional settlements the insured at the end of the 20 year tontine period, *if then living and in good standing,* was entitled to continue his policy as a "Fully Paid-up" policy without the payment of further premiums, and *in addition* to receive his share of the Survivorship Investment Fund, then apportioned to his policy, in cash. Receipt by him of this cash, however, had no effect on his policy of life insurance. That continued as a fully paid-up policy for its original face amount.

The insured, however, *subject to satisfactory evidence of insurability,* could use his cash payment to buy an additional "Fully Paid-up Non-Participating Life Policy" for such amount as might be purchased at the company's then published single premium rate applicable at the then attained age of the insured, obviously as any pros-

pective policyholder might do, if then insurable and at the same age, with an equal amount of cash. Or the insured might surrender his policy for its then cash surrender value of $6,100, since that sum was the legal reserve on a 20 Payment Life Non-Participating Policy for $10,000 issued at the age 35 (see R. 20—Table 1, Cash and loan values) and *in addition* receive in cash his share of the Survivorship Investment Fund then apportioned to his policy at the end of the tontine period.

If the insured, however, failed to exercise any of the options available to him within three months from the end of the survivorship investment period the contract provided that the amount apportioned to his policy should be paid in cash.

In view of these "Optional Settlements" provisions it is clear, we submit, that the amounts held by respondent in the Survivorship Investment Fund during the calendar year 1929 were not held against insurance in force and unmatured. This fund was to be apportioned only at the end of the tontine period of 20 years to the surviving members of the class then entitled thereto, when for the first time a surviving policyholder might purchase additional fully paid up insurance in the event of which the amount paid became an insurance premium and thereupon contributed its share to the company's legal reserve. *Helvering* v. *Inter-Mountain Insurance Co., supra.*

Clearly the annual contribution to the Survivorship Investment Fund of $64.60 called for by the

policy contract (R. 20) was an arbitrary amount and not actuarially computed. It did not represent a life insurance premium but a Survivorship *Investment* as provided by the contract which the Company was required to hold for distribution to those policyholders who survived to the end of the tontine period. On December 31, 1928, and December 31, 1929, respectively, the Survivorship Investment Fund under the specific terms of the policy contract constituted not a life insurance reserve but a fixed liability of the Company which, if the Company was to remain solvent, it was required under the laws of Illinois to carry as "a distinct and separate reserve liability." This fund was in no wise based upon the contingency of death. Death, on the contrary, terminated the right of the policyholder, his estate or his beneficiary to share in the distribution of the fund. In life insurance, however, death matures the policy as a claim on the legal reserve held for all of the Company's policyholders as a *group*.

In *Minnesota Mutual Life Ins. Co.* v. *United States,* 66 C. Cls. 481, certiorari denied, 279 U. S. 856, the same controversy in the case at bar was involved except that the amounts there in issue were the dividends of a mutual life insurance company set aside in a fund provisionally ascertained and held by the company and, as here, awaiting apportionment to the surviving members of the class of policyholders entitled thereto at the end of the

tontine period. Section 3497, General Statutes of Minnesota, 1913, provided that the amount of such apportioned surplus, plus the actual interest earnings and accretions of such fund should be carried—

> as a distinct and separate liability to such class of policies on and for which the same was accumulated, and no company or any of its officers shall be permitted to use any part of such apportioned surplus fund for any purpose whatsoever other than for the express purpose for which the same was accumulated.

In that case it was contended, as it was contended here, that the so-called reserve required to be so held constituted "reserve funds required by law" within the meaning of the Federal statutes, notwithstanding that the distribution there to be made, as here, was *contingent* upon survivorship. The contention was denied because, as here, the fund held was not held on account of *life insurance in force*. The so-called reserve in that case and, we most respectfully submit, the so-called reserve in this case were "solvency" reserves required by state law to keep the Company in a sound financial condition, and not the deductible "reserve" contemplated by the Revenue Acts. *McCoach* v. *Insurance Co. of N. Amer.*, 244 U. S. 585.

The total liability of the Company on the "Survivorship Investment Fund" in the present case is in no way dependent on the mortality of the

group. In an insurance risk the company must write enough policies so that the laws of probability will make it reasonably safe. In the present type of policy, where the company pays out only what it gets plus interest, the company is as safe with one policy as with a hundred thousand. It takes exactly the same risk as a savings bank, and no more. Therefore, the funds necessarily are required to be kept separate from the funds securing the life risks of a group.

In distinguishing this case from *Helvering* v. *Inter-Mountain Insurance Co., supra,* the court below said (R. 33):

> It is apparent from the language that the determining element [in the *Inter-Mountain* case] was the fact that the matured coupons no longer represented contingent liabilities.

The court went on to say that the survivorship feature created uncertainty (1) as to the beneficiary, and (2) as to the amount which any beneficiary would receive. These facts the court said "effectively distinguish matured liabilities upon coupons, noncontingent in character [as in the *Inter-Mountain* case], from the contingent liabilities protected by the survivorship investment fund." Clearly, the court in so holding misconstrued the decision in *Helvering* v. *Inter-Mountain Insurance Co.* The test laid down in that case is, as we have shown above, whether the fund (the

legal reserve) is held to meet *life insurance* risks; the test is not, as held by the court below, whether the fund is set aside to meet contingent liabilities. This appears clearly in the *Inter-Mountain* case, where this Court said (p. 690):

> Life insurance matures only upon the death of the insured *and the life reserve is based upon that contingency* * * *. (Emphasis supplied.)

Furthermore, even under the rule adopted by the court below, the respondent would not be entitled to the deduction. The amount for which the insurance company is liable under the survivorship investment feature of the policies here involved does not depend upon any contingency. That amount could be determined by a mathematical computation of the premiums paid, plus interest. From the point of view of the insured, the benefit was contingent but from the point of view of the Company the sum for which it would be liable to the group was certain. The bare possibility that none of the group might survive, while it might wipe out the liability entirely, does not make the amount of liability to that group uncertain. It has been squarely held that reserves for unreported death losses, which may never have to be paid, are not insurance reserves. *New York Life* v. *Edwards, supra.* The real distinguishing characteristic of an insurance reserve is the fact that it must be computed on the basis of the laws of probability

exemplified in the mortality tables. It is this that makes the amount of liability to the policyholders as a group uncertain and contingent on the number of deaths. Contingencies which affect the benefits to be received by the individual policyholder are immaterial.

The court below also stated (R. 35) that "life insurance today is not limited to policies for the payment of losses in case of death", giving as an example the fact that endowment insurance is payable not only on death, but upon surviving for a specified period. Therefore, the court thought that since the survivorship investment fund in the present case, which provided for the payment of the accumulated funds to the survivors, was attached to a policy providing for payment on death, it "was not essentially different from endowment insurance." Accordingly, the court considered that the survivorship investment feature of the policy in this case constituted life insurance.

It is not at all clear that the endowment feature of an endowment life insurance policy is life insurance, since that feature does not involve payment on the death of the insured. On the contrary, it is a payment only in the event he lives, and in computing the reserves on such policies, the part of the premium for pure endowment is separable from that part which pays for life insurance during the term of the endowment. However, it is sufficient to point out here that endowment policies are not

involved in the present case. Reserves for endowment policies must be actuarially computed. Such policies do not, as in this case, simply divide among the survivors whatever amounts are paid in plus interest. They are obligations for a specific sum. In order to determine the premium necessary to provide for that sum, it is necessary for the company to estimate the number who will not survive by using mortality tables, and to assume the risk that the survivors will be in excess of that number. In this case the amount of liability of the company can never exceed the amount paid in by the policyholders plus interest. The only risk taken is the *business* risk of not earning the interest agreed on. This risk is not in any way contingent upon either the death or the continued life of the policyholders. The policyholders are joint tenants in a fund which the company agrees to invest for them at a guaranteed rate, keeping the profits over and above that rate.

Furthermore, though the survivorship investment fund is attached to a twenty year payment life insurance policy, there is no logical relationship between the two. In an endowment policy, the life feature assures the payment of the face of the policy if the insured does not survive. The amount of the endowment determines the amount of the life insurance; the period before maturity of the endowment determines the length of the term

of the insurance. In the present policy the amount paid into the survivorship fund is arbitrarily fixed. The amount paid to any individual survivor is not fixed in advance, and has no logical connection with the amount of life insurance, other than the fact that the two are permitted by the law of Illinois to be incorporated in a single document.

The court below also referred to the policy in this case as an example of a semi-tontine policy (R. 35), and stated that "contracts of endowment or *tontine* character * * * are properly insurance contracts." It is submitted that a semi-tontine policy is in the nature of a deferred dividend policy, and that reserves for deferred dividends are not insurance reserves. However, no semi-tontine policy is involved in this case. The arbitrarily fixed premiums paid to the survivorship investment fund are not dividends in any sense.

The use of the word Tontine in connection with life insurance, which originated from a speculative scheme devised by Leonardo Tonti, has been briefly described by Willey in his work on Life Insurance as follows (pp. 28–29):

> This peculiar word is derived from the name of an Italian, Leonardo Tonti, who first suggested the form of investment, or speculation, which now goes under the name of a Tontine. It is a fund subscribed with the understanding that it will accumulate for a time, and thereafter be divided amongst the surviving contributors. Ton-

tines are now practically unknown, and have been little used since the beginning of the 19th century. The word is frequently used in life insurance to distinguish a certain form of surplus, spoken of as a—

Tontine Dividend.—This form of dividend was popular so long as it was the practice to forfeit entirely the policy value in event of the insured discontinuing payment of premiums. When the practice of guaranteeing liberal surrender values arose, the advantages in the Tontine Dividend form of distribution to a great extent disappeared. Policies which were entitled to a Tontine Dividend were placed in a class by themselves, and the premiums were accumulated for the specific benefit of the members of that class. The expenses of management and claims by death applicable to the class were charged out, and at the end of the Tontine period the aggregate policy values were also deducted from the fund. The remainder was the surplus which fell to be distributed amongst the policyholders then existing. Usually also the right was given at that time to withdraw the entire policy value. At the termination of a Tontine period, therefore, the entire fund contributed by the members of any specific class was understood to be closed out.

Semi-Tontine Dividends.—This form was introduced after it became customary to pay surrender values on the discontinuance of policies after being three years in force. It

is practically the equivalent of a deferred dividend policy, and the latter name is now generally preferred.

The resemblance between the survivorship feature of this fund and the original tontine investment speculation is obvious. An amount arbitrarily determined is allowed to accumulate at interest and is divided among the survivors. The speculative nature of the plan may be what influenced the legislature of Illinois to limit the contributions to 25% of the premiums of the policy to which it is attached. There certainly is no logical limit to the amount which might be paid in and distributed in this way. However, resemblance to Tonti's obsolete device, or its subsequent modification, has no relevance to the definition of life insurance reserves under the Revenue Act of 1928.

CONCLUSION

Tested by the principles announced by this Court in *Helvering* v. *Inter-Mountain Insurance Co., supra,* and in the prior decisions of this Court to which reference has been made, the so-called reserves held by respondent and in issue in this case did not constitute "reserve funds required by law" within the meaning of either Section 203 (a) (2) of the Revenue Act of 1928 or the laws of the State of Illinois.

To allow insurance companies to deduct from gross income a percentage of so-called solvency reserves securing pure investment contracts is to

give them an unwarranted advantage over other investment concerns which are compelled to carry reserves. The practical justification for the technical definition of life insurance reserves adopted by the Court is that it avoids giving an unfair advantage or incentive to life insurance companies to compete in the investment field. That consideration was emphasized by this Court in *Helvering* v. *Inter-Mountain Insurance Co., supra,* as follows (p. 690):

> As the Act does not permit corporations other than insurance companies to make deductions of the kind here under consideration, "reserve funds" may not reasonably be deemed to include values that do not directly pertain to insurance.

It is respectfully submitted that the decision of the court below is erroneous and should be reversed.

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APPENDIX

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 203. NET INCOME OF LIFE INSURANCE COMPANIES.

(a) *General rule.*—In the case of a life insurance company the term "net income" means the gross income less—

* * * * *

(2) *Reserve funds.*—An amount equal to the excess, if any, over the deduction specified in paragraph (1) of this subsection, of 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, * * *.

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

ART. 971. *Tax-exempt interest and reserve funds.*—Under paragraphs (1) and (2) of section 203 (a), life insurance companies are entitled to deduct from gross income:

(1) Interest which is exempted in the case of other taxpayers by section 22 (b) (4) and articles 84–88; and

(2) Four per cent of the mean of the reserve funds held at the beginning and end of the taxable year, without any abatement on account of tax-exempt interest. (See decision of United States Supreme Court in the case of *National Life Insurance Co.* v. *United States* (277 U. S. 508).) The reserve deduction is based upon the reserves required by express statutory provisions or by the rules and regulations of the State in-

surance departments when promulgated in the exercise of a power conferred by statute; but such reserves do not include assets required to be held for the ordinary running expenses of the business nor do they include the reserve or net value of risks reinsured in other solvent companies to the extent of the reinsurance.

In the case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, it is required that reserves thereon be based upon recognized tables of experience covering disability benefits of the kind contained in policies issued by this particular class of companies. Reserves maintained to provide for the ordinary running expenses of a business, definite in amount, and which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, reinsurance, and unpaid brokerage will not be considered. A company is permitted to make use of the highest aggregate reserve called for by any State in which it transacts business, but the reserve must have been actually held as shown by the annual statement. Generally speaking, the following will be considered reserves as contemplated by the law: Items 7–11 of the liability page of the annual statement for life insurance companies, and items 16–19 and 26 of the liability page of the annual statement for miscellaneous stock companies, if a life insurance company is also transacting other kinds of insurance business. If other reserves are claimed, sufficient information must be filed with the return to enable the Commissioner

to determine the validity of the claim. Reference should be made to the item in which the reserve appears in the annual statement and to the State statute or insurance department ruling requiring that such reserves be held. *Only reserves which are so required, which are peculiar to insurance companies, and which are dependent upon interest earnings for their maintenance will be considered.* (Italics supplied.)

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